

THE CO-OPERATIVE FEDERATION OF AUSTRALIA

AN INVESTIGATION INTO CO-OPERATIVE
ATTITUDES AND REQUIREMENTS OF A
CO-OPERATIVE BANK AND AN ASSESSMENT
OF ITS COMMERCIAL VIABILITY

MAY 1982

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SECTION I: INTRODUCTION

1. We have appreciated the opportunity of working with you on this assignment. Since we forwarded to you our proposal dated January 1982 we have had the benefit of meeting with the Steering Committee on two occasions and obtaining further background and views from the Committee.
2. We have also had the opportunity of working with Mr. Martin Stroethoff - Assistant General Manager of the D.G. Bank of Frankfurt, West Germany. In conjunction with Mr. Stroethoff, we have interviewed senior management of several building societies and credit unions in New South Wales and Victoria. We have also had the opportunity to meet with representatives of the Perth Building Society in Western Australia. Furthermore we had several discussions with Mr. J. Oliver who was formerly with the Rural Bank of New South Wales.
3. We record our appreciation of the assistance given to us by those mentioned above and also Mr. Rawlinson of the Co-operative Federation of Australia and Mr. Freeman of the Co-operative Federation of N.S.W. Limited.
4. Our proposal segmented the assignment into three steps:
 - Step 1: Objectives Setting
 - Step 2: Interviews
 - Step 3: Analysis and Report Presentation
5. The objectives we were given were to:

"Assess from a wide cross-section of co-operatives their attitudes towards and requirements of a co-operative banking facility and to prepare an initial report to indicate whether such a co-operative banking facility has any chance of commercial viability."

and to achieve this result we proposed the following terms of reference:

- (a) interview a pre-determined list of co-operatives to determine their attitudes and requirements of a co-operative banking facility;
 - (b) from these interviews assess the likely commercial benefits of a co-operative banking facility;
 - (c) ascertain the likely costs involved in the establishment of a co-operative banking facility;
 - (d) using the costs and benefits derived in (b) and (c), prepare a feasibility report assessing the commercial viability of a co-operative banking facility.
6. As the assignment progressed, we found that the answer to the bank's commercial viability rested heavily on the support it could obtain from building societies and credit unions. Some members of these movements have already undertaken investigations in respect of banking licences. We therefore held a number of discussions with members of these movements, exceeding both our terms of reference and our initial time scale.

SECTION II: SUMMARY OF CONCLUSIONS AND RECOMMENDATION

7. The following are the main conclusions reached in our investigations:

Co-operative Reaction to the Co-operative Bank

- (i) that generally co-operatives were favourably disposed towards the concept of a co-operative bank. Their support was, however, qualified and many expressed reservations about the bank's likelihood for success;
- (ii) the consensus among co-operatives was that the bank would operate:
 - . on commercial principles and at commercial rates of interest
 - . at least initially, as a wholesale bank, with representation in State capital cities, dealing only with building societies, credit unions and co-operatives
 - . on the basis that it would provide limited services in the short term, but full commercial services in the longer term;
- (iii) that the majority of co-operatives, at least in the short term, believe they will not receive any tangible advantage from the establishment of the co-operative bank but, nevertheless, were willing to purchase equity and transact with the bank. Many believed that in time, they may have greater access to finance at favourable rates because of the marshalling of co-operative funds;

- (iv) that some co-operatives saw potential disadvantages caused by the bank in relation to the phasing out of government assistance (such as rural credits) and the possible need for them to comply with certain co-operative bank directives;
- (v) the majority of co-operatives believed that the shares of the co-operative bank should be allotted according to the proportion of the equity subscribed. A slight majority also believed that representation for the three movements on the board of directors should be proportionate to the size of shareholding;
- (vi) co-operative support for the bank rests upon its structure and mode of operation. Should an indepth feasibility study recommend a bank that does not meet the requirements of trading co-operatives, they are unlikely to give the bank strong support. The main products that should be offered in the first instance by the bank are cheque clearing facilities, and deposit and loan facilities. In the longer term, opportunities to diversify the product base should arise.

Building Society and Credit Union Reaction to the Co-operative Bank.

- (i) that building societies and credit unions would benefit from participation in the co-operative bank by:
 - . being able to enter financing fields that are currently not available to them, thereby diversifying their product portfolio
 - . having access to a cheque clearing system that may enable them to provide personal chequing facilities to their customers at a reasonable cost

- . having lines of stand-by credit to enable an extension of their lending facilities
 - . having access to a wider pool of potential customers through the provision of cheque-type banking services
- (ii) the potential disadvantages to both movements are:
- . should a co-operative bank deal directly with the public, some existing and potential customers may choose to deal with the bank directly rather than with an intermediary such as a building society
 - . they may be forced to subsidise the other movement and/or the co-operative movement.

Commercial Viability of the Co-operative Bank

- (i) in the future banks will tend to become specialist institutions and develop differentiated products. A new bank, such as the co-operative bank, will need to adopt this strategy because it would lack the capacity to serve all markets;
- (ii) in the short term, the co-operative bank is unlikely to be profitable primarily because it will be unable to attract from the outset, a deposit base of sufficient size to cover all operational costs;
- (iii) we believe the advantages that will accrue to building societies and credit unions will lead to these organisations agreeing to meet substantially higher cheque clearing charges than they currently pay;

(iv) in time, the co-operative bank will be commercially viable provided it has sufficient support from:

- . building societies
- . credit unions
- . trading co-operatives

8. Our recommendation is that the steering committee should be extended to include representatives from the building society and credit union movements. Provided there is sufficient support from both these movements, the reconstituted body should plan for the implementation of an in-depth feasibility study which would investigate the costs and benefits of a co-operative bank's future operation.

SECTION III: ANALYSIS OF INTERVIEWS WITH SAMPLE CO-OPERATIVES

Introduction

9. To determine individual co-operative's views on a co-operative banking organisation, the Co-operative Federation and ourselves chose a representative sample of twenty-five co-operatives to interview. Due to geographical and timing constraints we were unable to interview two co-operatives; a third co-operative, Golden Circle Cannery in Queensland, declined to be interviewed. Appendix A lists the remaining twenty-two co-operatives that participated in the survey.
10. The survey was conducted for the broad purpose of determining the attitude held by co-operatives to the concept of a co-operative bank and its likely role in the Australian finance market. The method used to determine those views was to send each co-operative a questionnaire at least one week prior to our interview. In this way co-operatives could be prepared for the discussion that was held in their premises at a later date.

Content and Structure of Survey

11. The questionnaire used in the survey (refer Appendix B) was designed to elicit answers to a range of questions, including the following:
 - . the financial position of individual co-operatives
 - . general attitudes of co-operatives to the formation of a co-operative bank
 - . the co-operative's understanding of the concept of a co-operative bank

- . the perceived advantages and disadvantages of such a bank
 - . the co-operative's willingness to be a shareholder of the bank and to transact with the bank as a borrower, lender or user of other banking services.
12. The structure of the questionnaire was designed to elicit detailed responses from co-operatives rather than simple yes and no answers. An analysis of these responses follows. The tabular results from our interviews appear as Appendix C.

Analysis of Results - General Attitudes

13. Generally co-operatives interviewed were favourably disposed to the concept of a co-operative bank. However, willingness to support the bank was quite often conditional upon a variety of factors. "It all depends" was a common response. The uncertainties associated with how the bank would be established and operated meant that responses were indicative only. While the results of the survey may be interpreted as encouraging to the formation of the bank, such encouragement may not always result in direct support particularly when the bank is in its initial stage of operation. The level and breadth of this initial support will be vital in determining the bank's ability to attract customers.
14. Some doubt was expressed by respondents as to:
- . the likely backing for the establishment of such an entity as a co-operative bank both within the co-operative movement and the wider business community

- . the ability of the bank to compete in the open market, particularly its commercial viability given the trend to greater competition for funds and the need to offer commercial rates.

15. Reservations were also expressed regarding:

- . the ability of the bank to attract business away from the traditional banking areas
- . the expertise and resources required in both establishing and operating such a bank
- . the justification for another bank, albeit new in name and membership, but offering services currently available through normal banking channels.

16. The co-operatives interviewed generally held the view that no tangible advantage would accrue to them from the establishment of a co-operative bank based on commercial principles. Most of their financing needs can be met by the commercial banking system. Co-operative willingness to be involved with the bank often related to the present financial position and size of the respondent co-operative. Few expressed any real dissatisfaction with present banking services. The majority envisaged no new demand for bank services nor restriction of future activities due to the inability of banks to service their needs. The larger co-operatives particularly, by the very size of their dealings, have negotiated quite acceptable arrangements with their bankers. Reasons why some co-operatives may not be able to support the bank were:

- (i) barriers arising from present commitments;
- (ii) the non-acceptance of further likely controls;

- (iii) the uncertainty of returns; and
 - (iv) the breaking of established relationships with commercial banks.
17. While the smaller co-operatives were perhaps less tied to traditional arrangements, and less well serviced, their impact on the viability of the bank may not be substantial. The ability to offer competitive rates and to lure the larger co-operatives away from their traditional bank will thus be an important determinant of the success or failure of the scheme.
18. A distinction needs to be drawn between the short and longer term objectives of establishing such a bank and its envisaged operations. Attitudes of respondents tended to vary in terms of the time horizon being discussed. This included qualification of government involvement, services expected in the short and longer term and reservations regarding the level of initial involvement in the scheme as opposed to future dealings with the bank once it had established itself in the market.
19. It would appear that the "co-operative spirit" does not spread across co-operatives, but is instead, only relevant within co-operatives. Various comments were tendered regarding the philosophies of co-operation and their applicability in the context of involvement with the bank. Clearly the marketing of the benefits and principles of wider co-operation would assist the establishment of a co-operative bank.

Advantages/Disadvantages Accruing to Co-operatives from a Co-operative Bank

20. The advantages identified by respondents related mainly to the longer term and ranged from benefits to the co-operative movement generally to possible gains for

individual co-operatives. Responses under this heading included:

- . the improved status and commercial position of co-operatives in the market place
- . the consolidation of the co-operative movement and furtherance of co-operative principles
- . the respectability of being associated with such an undertaking
- . a more sympathetic hearing of applications for funds and understanding of co-operative problems
- . improved servicing in the area of financial advice
- . possible savings and improved returns through gains in economies and efficiencies in operation
- . improved access to finance
- . a marshalling of co-operative funds and co-ordination of funds transfer through the use of a 'common pool'.

21. While improved access to loan finance was cited by eight of the respondents as an advantage, nine saw no particular benefit accruing to them in this regard from formation of the bank. Six co-operatives saw the bank as providing funds at a cheaper rate. This latter comment is in conflict with the perceived need for the bank to compete commercially with other banks. Should cheaper rates be a condition of borrowing, its impact on margins may threaten the commercial viability of the bank. The same principle also applies to depositing funds with the bank at higher than commercial rates. Previous experience of some co-operatives with 'pooling' also made them sceptical of the bank's ability to place funds at higher rates than

those attainable by the individual co-operative in the marketplace.

22. The costs of resources and manpower, particularly in offering full banking services, were mentioned as obstacles for the bank in its formative years. The only specific disadvantage put forward was that the establishment of the bank may provide the government with the excuse for ending some co-operatives' enjoyment of the rural credits facility of the Reserve Bank of Australia. Certain resistance was expressed regarding compliance with bank directives. Such controls and any curtailment of present co-operative activities could therefore be interpreted as a potential disadvantage of membership and transacting with the bank. In other words, if the new bank provides no tangible advantage to individual co-operatives while imposing restrictions, which its competitors would not, there is no incentive for a co-operative to turn its back on its traditional banker.

Understanding of the Term 'Co-operative Bank'

23. Interpretation of the term 'Co-operative Bank' varied markedly from that of:
- . a bank formed of co-operatives, operated by co-operatives in the interests of co-operatives; to
 - . just another bank with a different name.
24. The majority of respondents believed that in the longer term the bank should provide full banking services. It would have to compete, therefore, for customers on the open market and offer services to the public at large. Recognition was also given to the need to attract funds away from existing finance houses and that restrictions on banking activity could jeopardise the commercial viability of the bank. Reliance on co-operatives as the sole source

and users of finance was considered to be untenable. All respondents, however saw ownership of the bank being restricted to co-operatives.

Operating Characteristics and Role of Bank

25. Opinion regarding the operating characteristics and role of the bank varied depending on the time period being considered. In the short term the operation of the bank was seen as being restricted to that of a wholesale bank, the level of services being highly centralised and concentrated at the national and state level. The bank's role would be one of marshalling the surplus funds of co-operatives, building societies and credit unions and then redistributing them in commercial transactions. The benefits to be gained in the short term would be:
- . increased return on funds through pooling and investment at higher rates than available to individual co-operatives
 - . the minimisation of holdings of liquid reserves by co-operatives, given the assurance of access to funds at short notice, with a commensurate reduction in borrowing costs
 - . the avoidance of significant costs of establishing a local banking network.
26. As a wholesale bank, the bank would be restricted to the provision of specialist services geared to the needs of individual co-operatives rather than their members. Extension of services to those offered by commercial banks with all the traditional banking services, was seen to be a long term objective of the bank. The initial concentration of services and restriction to a central, clearing house operation should provide economies of scale and enable the bank more easily to overcome problems in

its formative years. Full services at the local and regional area were seen as being cost prohibitive in the short term, and not necessary. We believe that the basic services that must be offered from the outset to obtain trading co-operative support are cheque clearing facilities, and deposit and loan facilities.

27. The co-operatives interviewed believed that the Board of Directors should consist of representatives from co-operatives, building societies, credit unions and also outside directors with specialist knowledge. No direct involvement by co-operatives was envisaged in policy setting or management of the bank. Representation on the board was a contentious issue although a slight majority believed it should be proportionate to the size of shareholding. Others believed that no sector should be able to control the bank and therefore each sector should have equal representation on the Board.
28. The consensus was that shareholding should be restricted to co-operatives and that individual co-operatives need not have equal shareholdings. Thus larger co-operatives could have a larger shareholding than smaller co-operatives and, therefore, would be entitled to greater voting power at the Annual General Meeting. This view is not consistent with the co-operative concept of one member, one vote. Transfer of shareholding should be restricted to co-operatives unless the Board approved otherwise. Some disquiet was expressed by a minority of respondents as to the predominance of one sector's or member's holding and the power to influence bank policy at the Annual General Meeting.
29. Government involvement in the bank was not seen as necessarily desirable. Benefit was seen in gaining initial government support and continued involvement as a user of the bank. However, the bank would have to compete on an equal footing with commercial banks and could not

expect favoured treatment. No clear cut preference existed for establishment of the bank under either separate statute or the Banking Act.

Co-operatives' Willingness to Purchase Equity in the Co-operative Bank

30. Generally, the majority of respondents were in support of the concept and fifteen were willing to subscribe capital.
31. The level of potential investment varied proportionately to size. The size of the investment ranging from:

	<u>Number of Respondents</u>
. less than \$ 20,000	3
. \$ 20,000 to \$ 50,000	2
. \$ 50,000 to \$100,000	3
. \$100,00 to \$250,000	5

One respondent was willing to purchase a percentage of the bank's authorised capital; another indicated willingness to be a shareholder but did not nominate an amount.

Attitudes of Co-operatives to Transact with the Co-operative Bank

32. All respondents were willing to deposit funds and use the services of the bank. Sixteen were willing to direct funds away from their present investment portfolio. No inhibition was contemplated given the bank was accorded the status of an authorised trustee investment.
33. The main characteristics of the respondents were:
- . thirteen classified themselves as net borrowers, nine as net lenders and fifteen experienced marked seasonal fluctuations in finance requirements

- . all used chequing and overdraft facilities of commercial banks
 - . thirteen have foreign exchange dealings for which they usually take forward cover to protect against currency fluctuations
 - . fourteen use lease finance, often for substantial amounts
 - . thirteen use the short-term money market
 - . eleven had external restrictions on financing
 - . nine co-operatives use the rural credit facilities of the Reserve Bank of Australia.
34. The majority of respondents saw the use of services being restricted to co-operatives and not the individuals that comprise their membership. Whereas most believed services should be concentrated at the national and state level in the short-term, agency arrangements were mentioned as a possibility for future extension of services to the members of individual co-operatives. Agency arrangements could be with participating building societies, credit unions and/or trading co-operatives.
35. Whereas most co-operatives appeared willing to transact with the co-operative bank, most expressed reservations regarding:
- . the potential for return and
 - . the limited advantages of participation.
36. All expected commercial rates of return as shareholders and depositors, while three expected less than commercial rates on loans. No marked preference was expressed regarding the nature of profit distribution, whether it be

by dividend or rebate; fourteen, however, favoured weighting toward the borrower rather than the depositor. As borrowers, eighteen said they needed an assurance as to the continuity of supply of loan funds. Many expressed some reservation regarding the impact that involvement may have on their established banking arrangements.

37. The issue of the need for compliance with co-operative bank restrictions and controls over co-operatives' activities was less than favourably received. Only seven respondents said they were in favour of control and eleven qualified their support for the concept, while accepting the need for minimum regulation.

Summary

38. The need for the bank to compete on the open market for funds, to operate within commercial rates and the costs of entry to the market were all cited as reasons for scepticism regarding the viability of the scheme. The support for the concept was therefore qualified in terms of its potential for success. Current satisfaction with present banking arrangements and the current uncertainty within the financial community post Campbell were also noted as grounds for questioning the extension of co-operative activities into this area.
39. The advantages to be gained from a co-operative bank were not clear to a majority of the co-operatives that we interviewed. The potential benefits to the building societies and credit unions, however, were generally recognised. The recurring co-operative concern would seem to boil down to a question of "what is in it for us as trading co-operatives?". On the basis of the interviews conducted, the answer to this question is elusive.

40. Whereas many co-operatives indicated support for the bank, their support was conditional upon its structure and mode of operation. We believe that their replies were indicative only and based on information that at this time is sketchy. Should an indepth study recommend a bank that does not broadly meet their requirements as outlined in this report, we believe that many co-operatives would not support such a bank.

SECTION IV: COMMERCIAL VIABILITY OF THE CO-OPERATIVE BANK

41. In the previous Section, we discussed the reaction of trading co-operatives to the establishment of a co-operative bank. In general, we concluded that they were likely to support the bank.
42. The Federal Government has advised the Co-operative Federation of Australia that approval for the establishment of the bank is likely to be partly dependent upon the support it would receive from three sectors:
- (i) building societies
 - (ii) credit unions
 - (iii) trading co-operatives
43. We have had a number of discussions with building societies and credit unions. These discussions lead us to believe that both would receive benefits from the establishment of a co-operative bank and, therefore, their support is likely. It should be emphasised, however, that their commitment to the bank is a vital factor to its successful operation.
44. We believe the potential advantages for the building society and credit union sectors include:
- . the existence of a cheque clearance facility is likely to enable the provision of personal chequing accounts to their customers at a reasonable cost
 - . entry to new and profitable financing areas, such as personal loans or leasing, may be facilitated, thereby diversifying existing product portfolios
 - . the co-operative bank may provide stand-by lines of credit which enable extension of each sector's lending activities should the need arise

- . increased market share should be achieved through the wide range of customers attracted to bodies that can offer full banking services to their customers in addition to more attractive interest rates than banks.

Co-operative Bank Operations

45. Existing Federal Government guidelines for the establishment of a new bank in Australia specify that the services to be provided must not only be wide-ranging but also must be available to the public generally. They should not be restricted to the membership or associates of a sponsoring organisation.
46. We believe that the future of banking in Australia is unlikely to be consistent with the above guidelines, and that bankers must differentiate their institutions from others in what has been essentially an undifferentiated service industry. There are signs that this is already occurring in Australia. The A.N.Z. Bank appears to have adopted a strategy of concentrating its efforts on the corporate market, and the Australian Bank has been selective in the products it offers and the customers to whom it offers those products.
47. Where competition between banks is intensive, the quality of service becomes more crucial. A co-operative bank, lacking the financial capacity to serve all markets equally well, must elect to serve fewer markets. It therefore may not conform to the above guidelines in the longer term.
48. The following strategies would appear suitable to the co-operative bank:
 - . develop innovative products to set itself apart from the opposition

- . focus on specific lending and non-lending areas
- . project an image to which particular customers will relate
- . develop sophisticated marketing and operational skills
- . emphasise fee generating services to offset narrowed lending margins.

49. We agree with the consensus of the co-operatives interviewed that the co-operative bank should operate as a wholesale bank providing services to building societies, credit unions and co-operatives. The justification for this belief is twofold:

- (i) firstly, it would be cost prohibitive to establish a banking network such as those of commercial banks. Furthermore, participating building society, credit union and some trading co-operative branch networks can serve as agents for the bank;
- (ii) secondly, should the co-operative bank deal directly with members of the public, building societies and credit unions may lose customers and are therefore unlikely to support the co-operative bank. Future investigation may, however, reveal that the co-operative bank should transact directly with the public to obtain a greater deposit base than it would otherwise have as a wholesale bank. This issue needs to be clarified with building society and credit union representatives at some future point in time.

50. Should the co-operative bank act solely as a wholesale bank, members of trading co-operatives would not be able to deal directly with the bank (unless they were also co-operatives). Those members requiring borrowing

facilities must, therefore, operate through their co-operative. The co-operative would borrow from the co-operative bank and on lend this finance to its members. It would be responsible for the collection of the debts and the overall repayment of the loan to the co-operative bank. In this way the operational costs of the co-operative bank would be minimised.

51. The services required of a co-operative bank by co-operatives include cheque clearing facilities, overdraft and standard deposit and loan facilities. There are a number of additional services, that can be highly profitable, in which the bank may specialise. They include:

- . corporate, government and international financing
- . funds and portfolio management
- . foreign exchange dealings and syndicated loan stand-by arrangements
- . leasing
- . insurance
- . underwriting of share issues and fixed/floating rate securities
- . travel arrangements
- . investment advice
- . business and economic research
- . safe deposit facilities.

52. The above services require expertise that can only be developed after gaining experience in providing them to customers. For this reason a new bank must obtain the requisite expertise from other financial institutions in the market place. Such expertise is costly to acquire, but is necessary to the successful establishment of a new bank.
53. Subsequent to our interviews with the representative co-operatives, it would appear that the co-operative bank, in its capacity as a wholesale bank, need be located only in State capital cities. A funds transfer between provincial cities and the co-operative bank can be effected via the commercial banking networks or by using participating building society, credit union or co-operative branch networks on an agency basis. Other services can be utilised by direct dealings with the bank in the capital city.
54. The interviews also indicated that a co-operative bank is expected to operate with commercial rates of interest. To do otherwise would lead to either a lack of support because the rates offered were uncompetitive, or finer margins and perhaps therefore leading to operational difficulties.
55. Interest rate margins of financial institutions are of utmost importance as they dictate the amount of funds placed with the institution and also the loan activity. Further to this, the cost of operations must be met out of the interest rate margin and from the profitability of other products.
56. We are advised that a typical bank interest rate margin is between two and four per cent. Merchant bank margins are usually finer and vary between three quarters and one and a half per cent. Whereas banks have large branch networks at significant costs, they also have a large proportion of

cheap savings (e.g. savings accounts and chequing accounts) that tend to subsidise their cost of operations. Merchant banks, on the other hand, must pay competitive rates to attract funds, but by not having branch networks and by concentrating their lending in lower risk areas, they can better afford the costs of higher gearing and hence operate on narrower interest margins.

57. The co-operative bank will be faced with the prospect of paying commercial rates for funds and therefore its margin must be finer than that of the commercial banks. It would appear that the margin on which it would operate will be between one and two per cent.
58. A further issue clarified by the questionnaire is that sufficient co-operatives are likely to become shareholders in the bank to ensure that co-operative interests would be protected. In the absence of such support, building societies and credit unions would need to purchase a greater shareholding and would, therefore, be likely to have greater control of the co-operative bank.
59. It should be noted that the Australian Bank is the commercial bank that is most similar to the co-operative bank as outlined above. It has an equity base of \$30m. From information that we have available it currently has a gearing ratio of four-to-one, and is experiencing losses in its banking department which are expected to continue for three to five years. The profits from its other products, however, are likely to result in a break-even situation in the short term.
60. We are advised that the Australian Bank plans to increase its debt/equity ratio towards fifteen or twenty-to-one which is the standard commercial bank gearing. Merchant banks, on the other hand, are often geared in excess of forty-to-one.

Commercial Viability of the Co-operative Bank

61. In order to determine the commercial viability of the co-operative bank, one must determine how it will operate and the resultant revenues and costs involved in providing its services.
62. In summary, we believe that at least in its initial years of operation, the bank will be a wholesale bank providing services only to building societies, credit unions and co-operatives. It will be located in major State capital cities with a Paid up Capital of \$20m (but preferably it should be closer to \$30m) and an initial debt/equity ratio of four-to-one. In the following paragraphs we conclude that given these parameters, the co-operative bank is unlikely to be profitable in its formative years.
63. Starting from these operational assumptions, we have prepared a likely operating scenario as follows:

(a) Product Contribution to Overheads

The profits generated by the co-operative bank will result from a number of possible product areas which are detailed above. For a variety of reasons, not all of these products can be offered in the short term.

It is difficult at this time, and beyond the scope of this report, to identify the products that the co-operative bank will offer from its inception. We believe, however, that they are likely to include the following:

- . cheque clearing facility
- . foreign exchange dealings and syndicated loan stand-by arrangements

- . funds and portfolio management
- . leasing
- . insurance
- . travel.

In addition to the above list, a major source of revenue will be the margin between the cost of funds and the interest at which those funds are invested (or lent out).

It is impossible at this time to estimate with some degree of accuracy the contribution to profits that each of the above products would make. It is possible, nevertheless, to make broad estimates of profitability generated from some of those products.

Commencing from the base that share capital will be \$20m and the bank's gearing will be four-to-one, total funds in the bank will be \$100m. Not all of these funds need be drawn from domestic sources. We envisage that the co-operative bank will be able to establish offshore lines of credit should they be required or should they have an advantage over domestic sources.

If one assumes that the bank must comply with existing Reserve Bank guidelines for trading banks, the amount for lending will decrease from the total funds available (\$100m) to \$75m because of the following:

- (i) Statutory Reserve Deposits: seven per cent of trading bank assets must be invested in statutory reserve deposits. Based on an

interest rate of 5 per cent it would currently generate a return of \$350,000 p.a. on \$7 million

- (ii) Liquid Government Securities: eighteen per cent of funds must be invested in cash and liquid government securities. This would provide a return of approximately \$2.52 million p.a. based on a conservative interest rate of 14 per cent.

When one takes into account the cost of these funds, however, the costs will exceed the revenues realised. The R.B.A. guidelines, therefore, serve to narrow the overall interest rate margin even more. These investments can be ignored for our purposes if we assume that the return from them (11.48%) is used to pay dividends to the shareholders of the co-operative bank.

In reality, however, it is unlikely that shareholders would receive a commercial return on their investment in the initial years of the bank's operations because of the likelihood that term deposits will out-perform return on earnings for some years to come. Furthermore, the need to finance growth particularly from internal sources combined with a doubtful profitability picture would contribute to a lower than commercial return on shareholders funds.

Cheque clearing fees are unlikely to contribute significantly to profit because the fees would probably be based on the direct costs of the service. They can, therefore, be ignored in this analysis. It is important, however, that a commitment to using this facility is obtained from a substantial number of building societies and credit unions as a large through-put will assist in keeping

unit costs under control. From our discussions with both sectors, we believe the advantages that building societies and credit unions will obtain from the existence of a co-operative bank, such as cheque-type services, may lead to them being prepared to meet substantially higher cheque facility charges than they currently pay.

To summarise, the majority of product areas listed above are excluded from our calculations because we are not able to estimate with sufficient accuracy their contribution to profits. We have therefore, made the conservative assumption that they will break even. The net contribution from the cheque clearing facility is not expected to be significant and is therefore ignored also.

The profit margin on lending transactions can, however, be estimated and appears below. It is based on the assumption that \$75m will be available for lending. The remainder of funds (\$25m) is ignored because it must be invested according to R.B.A. guidelines and is unlikely to yield a positive margin. (We have assumed the return on those investments will be paid to shareholders as dividends.)

If one assumes that the profit margin on funds will be between one and two per cent, the net contribution of \$75m to overheads will range between \$0.75m and \$1.5m based on our assumptions above. For the co-operative bank to break even, overhead costs must therefore also range between \$0.75m and \$1.5m.

(b) Overhead Costs

In the preceding paragraphs we discussed the contributions to overheads from the products that the

co-operative bank is likely to offer from its inception. Additional costs must be incurred and these can be broadly classified as overheads. They include:

- (i) establishment costs
- (ii) leasing costs of computers, equipment and offices
- (iii) other operating costs.

The magnitude of these costs are dependent upon a number of operational decisions that must be made at future points of time. Only broad estimates of these costs are possible now.

Based on our estimates and the information that we have on the Australian Bank's limited operations, we believe that these costs may approach \$5m per annum. This amount is likely to exceed the net contribution from each of the product areas in the co-operative bank's initial years of operations. Should the operating costs be \$5m, a loan base of between \$250m and \$500m would be required to break even (assuming an interest rate margin of between one per cent and two per cent). That is, a gearing ratio between 13 and 25-to-one would be required if the co-operative bank's equity was to remain at \$20m.

One can, of course, alter the amounts of these variables. Table A demonstrates that should the per annum overhead costs of the co-operative bank be \$5m, only certain combinations of loan funds and interest rate margins represent a break even or profitable situation. Thus, if the interest margin was three-and-a half per cent, \$150 million of loan funds

TABLE A: PROFITS GENERATED (\$m)

% on Funds

	1	1½	2	2½	3	3½
100	1	1.5	2	2.5	3	3.5
150	1.5	2.25	3	3.75	4.5	5.25
200	2	3	4	5	6	7
250	2.5	3.75	5	6.25	7.5	8.75
300	3	4.5	6	7.5	9	10.5
350	3.5	5.25	7	8.75	10.5	12.25
400	4	6	8	10	12	14
450	4.5	6.75	9	11.25	13.5	15.75
500	5	7.5	10	12.5	15	17.5
550	5.5	8.25	11	13.75	16.5	19.25
600	6	9	12	15	18	21

TABLE B: TOTAL FUNDS/LOAN FUNDS (\$m)

Gearing Ratio

	4:1	8:1	12:1	16:1	20:1	24:1
\$15m	60/45	120/90	180/135	240/180	300/225	360/270
\$20m	80/60	160/120	240/180	320/240	400/300	480/360
\$25m	100/75	200/150	300/225	400/300	500/375	600/450
\$30m	120/90	240/180	360/270	480/360	600/450	720/540
\$35m	140/105	280/210	420/315	560/420	700/525	840/630
\$40m	160/120	320/240	480/360	640/480	800/600	960/720

would be required to produce a profit of \$0.25m. Table B indicates that should the amount of equity funds be \$25m a gearing ratio of eight-to-one would be necessary to provide \$150m in loan funds.

If, on the other hand, overhead costs of the bank were \$3m and the interest rate margin was one-and-a-half per cent, \$200m in loan funds would be required to break even. Should the equity funds be \$30m, a gearing ratio of approximately nine-to-one would be necessary to provide this deposit base.

Conclusion

64. Although it would appear doubtful that a co-operative bank would be profitable in its initial years of operation, it is quite possible that a professionally managed bank with a clear charter and direction will be profitable in the medium to long term.
65. Any conclusion must take into account the potential for profits of other products that our exercise has assumed will be in a break even situation. These may lessen the need for greater shareholders funds or gearing, and therefore would assist the co-operative bank to be profitable earlier than it otherwise would.
66. In conclusion, we believe that given the commitment of sufficient building societies, credit unions and trading co-operatives, a co-operative bank is likely to prove viable provided that the extent of its operations was limited to a wholesale activity at least in its initial years of operation. Its success would appear to be partly reliant upon how cost effective it can provide services to these movements. This can only be determined after a

complete feasibility study has been undertaken on the co-operative bank's likelihood for success.

67. We recommend that the steering committee be extended to include representation from both building societies and credit unions. Should the co-operative bank concept appear likely to obtain substantial support from these sectors, we recommend that the reconstituted body should plan for the implementation of an in-depth feasibility study which would investigate the costs and benefits of a co-operative bank's future operations.

68. We believe the feasibility study can be separated into three stages:

(i) Definition of the Bank's Charter

this stage would be primarily concerned with the market segments and products upon which the co-operative bank could concentrate its efforts. It should also investigate the framework under which the bank will operate and be located;

(ii) Economic Evaluation

this stage would incorporate an economic evaluation of the costs and benefits associated with the bank meeting its charter. In particular, it would ascertain likely operating costs and revenues that arise from the bank's operations;

(iii) Logistics of Establishing the Bank

in this stage, the means of establishing and operating the bank and in particular the procurement of the resources necessary to achieve this should be planned in considerable detail.

69. The elapsed time for the above three stages is difficult to predict at this stage. As a guide we consider it unlikely that the bank could be operational in less than nine or ten months.

CO-OPERATIVES INTERVIEWED

QUEENSLAND

Primac Association,
Brisbane. Qld. 4001

NEW SOUTH WALES

Banana Growers Federation Co-operative,
Murwillumbah. N.S.W. 2484

Curlewis Farmers' Co-operative,
Gunnedah. N.S.W. 2380

Dairy Farmers Co-operative,
Ultimo. N.S.W. 2007

Griffith Producers Co-operative,
Griffith. N.S.W. 2680

N.S.W. Sugar Milling Co-operative,
Broadwater. N.S.W. 2478

Rice Growers Co-operative Mills,
Leeton. N.S.W. 2705

Namoi Cotton Co-operative,
Wee Waa. N.S.W. 2388

VICTORIA

Ardmona Fruit Products Co-operative,
Mooroopna. Vic. 3629

Co-operative Insurance Co.,
Melbourne. Vic. 3000

Ibis Milk Products,
Shepparton. Vic. 3630

Murray Goulburn Co. of Australia,
Brunswick West. Vic. 3055

Phosphate Co-operative of Australia,
Melbourne. Vic. 3000

Victorian Producers Co-operative,
Melbourne. Vic. 3000

SOUTH AUSTRALIA

Associated Co-operative Wholesalers,
Adelaide. S.A. 5001

Berri Fruit Juices Co-operative,
Berri. S.A. 5343

Master Butchers Ltd.,
Kilburn. S.A. 5084

Murray River Wholesale Co-operative,
Adelaide. S.A. 5001

WESTERN AUSTRALIA

Grain Pool of Western Australia,
Perth. W.A. 6001

United Fruit & Vegetable Growers Co-operative,
Perth. W.A. 6000

Westralian Farmers Co-operative,
Perth. W.A. 6001

Fremantle Fishermen's Co-operative,
Fremantle. W.A. 6160

CO-OPERATIVE BANK QUESTIONNAIRE

Introduction

The purpose of the survey is to determine:

- . whether the existence of a specialist bank can be justified, and
- . if so, whether this need should be met by the formation of a co-operative bank to service the needs of co-operative member companies.

The principal objective of the study is to assess from a cross-section of co-operatives, their attitudes towards and requirements of, a co-operative banking facility. That is, a bank supported by and operated in the interests of co-operatives.

The questionnaire has been designed:

- . to provide input for an analysis of the financial sector's current servicing of co-operatives, and
- . to focus upon the opportunities and threats affecting the establishment of a co-operative bank in Australia.

Methodology

In conducting the survey it was considered appropriate to establish a sample group of potential users that would be representative of the co-operative movement and its needs. The co-operatives to be surveyed have therefore, been classified according to their major operating activity. That is:

- . Primary Production and Processing - Group A
- . Financing - Group B
- . Retail and Marketing - Group C.

The initial questions included within the body of the questionnaire have been designed to facilitate this classification. Later questions have been designed to establish the respondents' attitudes towards:

- . the envisaged operating characteristics of the bank as a whole, including the preferred organisational structure
- . the probable bank activities, and
- . the potential composition of users of the service and members of the bank.

The range of probable services offered by the bank have been presumed to include both:

- . the existing banking services available to co-operatives through commercial banking channels, and
- . services that are either not available or are currently inhibited by existing banking arrangements.

The results of the survey will be used to assess:

- . the level of commitment within the Australian co-operative movement to the concept of a co-operative bank, and
- . the extent of participation of individual co-operative groups in the scheme, either as shareholders, depositors and/or borrowers.

Questions to be Addressed to Participants in the Survey

1. General Background Information

(a) Nature and operating characteristics of the co-operative

- . composition of membership
- . class and type of industry
- . products handled and percentage of business attributable to each
- . markets served, local and/or overseas
- . seasonal patterns in the supply and demand for major products
- . customer profile and usual credit terms
- . supplier profile and usual credit terms

(b) Existing financial arrangements

- . the demand for and supply of funds
 - .. seasonality
 - .. the timing and movement in cash flows
- . nature and source of financing used by the co-operative
 - .. major suppliers of finance
- . existing banking requirements and current banking services used

- . the level of satisfaction with current banking services and the costs thereof
 - .. problems experienced with existing services
 - .. present interest and fee commitments
- . the level of overseas dealings and the co-operative's exposure to exchange rate fluctuations
- . the level of government subsidies and use made of government credit facilities
- . use of leasing and other forms of finance
- . past experience of co-operative and classification as "net" borrower or lender
- . the existence of restrictions and regulations over finance activities of co-operative
 - .. the nature of regulatory controls
 - .. by whom and extent
 - .. the existence of statutory or other limitations, e.g. trust deeds, articles of association, which limit the raising and application of funds.

(c) Proposed amendments to co-operative activities

- . planned expansions or contractions in co-operative activities and their potential impact on banking services and levels of finance
 - .. co-operative as a group
 - .. individual members of co-operative

- . can these plans be realised within present banking arrangements
- . what limitations do the present banking arrangements impose on the co-operative
- . how does the co-operative plan to finance growth in working capital and fixed investment.

2. Attitudes to Concept of Co-operative Bank

- . co-operatives understanding of the term "co-operative bank"
- . services expected of the bank. Would the establishment of such an entity enhance the achievement of co-operative objectives
- . the perceived benefits accruing to the co-operative as a member of the scheme
 - .. the expected returns
- . the willingness on the part of the co-operative to participate in the scheme
- . the attitude of the co-operative to the need for compliance with possible regulations imposed by a co-operative bank
 - .. the acceptability of the concept of a centralised system of fiscal control to:
 - ... ensure proper funds management
 - ... control lending budgets and liquidity requirements
 - ... oversee and foresee trends in deposits and withdrawals as well as financial trends generally
- . tax implications, if any, of membership.

3. Respondents' Attitude to Co-operative Bank as

(a) A Shareholder

- . the willingness of the co-operative to commit resources as capital
- . the levels of capital investment plus commitments of support in relation to the expected yield (either as cash or ancillary benefits)
- . the expectations regarding the level and nature of return on investment
 - .. dividend
 - .. interest rebate as a borrower
 - .. interest loading as a lender
- . the possible distinctions to be made between members as borrowers or lenders
 - .. the weightings to be applied in determining the distribution of profits
- . the envisaged capital structure of the bank
 - .. the co-operative's attitude to the level of gearing required to effect the raising of funds by a co-operative bank
 - .. the sectional representation required of members of the bank
- . the level of expected co-operative involvement in the determination of bank policy. Attitudes to
 - .. the nature of controls over bank activity
 - .. controls over transfer of equity

- .. the need for government involvement and level of support. Should the co-operative bank be established under a separate statute or operate as a commercial entity within existing banking laws
- .. possible restrictions on bank activity especially lending and borrowing
- . the range of potential services to be offered to members of the bank
 - .. traditional banking services such as
 - ... savings and deposit business
 - ... cheque clearing facilities
 - ... lease financing
 - ... portfolio management etc.
 - .. other services not presently available through existing banking arrangements
- . the co-operative's willingness, as a shareholder of the bank, to commit itself to bank regulations. For example
 - .. the imposition of minimum deposit holdings
 - .. the exercise of restrictions governing the application of co-operative funds

(b) A Depositor

- . the availability of funds for deposit with the bank. When and of what type
 - .. annual spread
 - .. short, medium or long-term

- . the current and expected return on funds
- . make up of current investment portfolio and the determinants of current investment policy
 - .. attitudes to risk and the protection required
 - ... floating charge
 - ... mortgage
 - ... unsecured
 - .. existing controls over the application of funds:
 - e.g. Speculative vs entrepreneurial capital
 - primary production, manufacturing vs mining
- . willingness to direct funds away from present portfolio
 - .. would the establishment of a co-operative bank attract co-operative funds. What minimum conditions would be necessary for this to occur
 - .. would the placement of funds with the bank be inhibited by present controls over co-operative investments
- . type of banking facilities to be made use of by
 - .. the co-operative as a whole
 - .. individual members of the co-operative

- .. would deposits be made by the co-operative acting for members or by individual co-operative members
- . the level of services demanded of the bank
 - .. national
 - .. regional
 - .. local
- .. how should this demand be satisfied. By a centralised or a distributed organisation structure
- ... the level of centralisation/dispersion of services.

(c) A Borrower

- . the need for funds, borrowing requirements of the co-operative. When and of what type
 - .. annual spread
 - .. short, medium or long-term
- . co-operative's attitude to costs of borrowing
 - .. the current and expected costs of funds.
Interest rates and fee structure considered necessary to attract the co-operative's business
 - .. use of a comparative base (the bond rate or ruling commercial rates). What range would be considered acceptable
- . the co-operative's need for assurances concerning the continued supply of funds

- . type of banking facilities to be made use of by
 - .. the co-operative as a whole
 - .. individual members of the co-operative
 - .. would the co-operative act as a borrower and refinancer to its members or would loans be made direct to individual co-operative members
- . the level of services demanded of the bank
 - .. national
 - .. regional
 - .. local
 - .. how would this demand be satisfied. By a centralised or distributed organisation structure
 - .. the level of centralisation/dispersion of services
- . the security for loans
 - .. floating charge
 - .. mortgage
 - .. unsecured.

TABULAR ANALYSIS OF QUESTIONNAIRE RESPONSES

<u>QUESTION</u>	<u>RESPONSE RATE</u>
<u>Existing Financial Arrangements</u>	
1. Is the co-operative	
- a net borrower of funds	13
- a net lender of funds	9
2. Nature of financing	
- banking system	21
- other	14
- seasonality	15
3. Banking services used	
- chequing	22
- deposit - short term and long term	7
- overdraft	22
- foreign exchange	12
- loans - short term and long term	16
- rural credits	8
- travel	1
- bank bills	3
4. Satisfaction with banking services	
- Yes	18
- No	4
Specific criticisms included	
- high rates of interest, fees and service costs	
- lags in funds transfer	
- quality of advice	
- inflexibility of arrangements	

<u>QUESTION</u>	<u>RESPONSE</u> <u>RATE</u>
5. Foreign exchange dealings	
- Australian dollars	3
- overseas currencies	11
- cover taken	13
6. Leasing	
- over \$1m	4
- less than \$1m	10
7. Existence of restrictions on finance activities	
- none	6
- Yes - Internal	6
External	11
8. Non banking system investment portfolio	
- none	7
- short term money market	13
- shares	2
- government securities	2
- debentures	1
9. Attitudes to risk with investments	
- risk averse	11
- not risk averse	1
10. Willingness to direct funds away from present portfolio	
- No	1
- Yes	10
- in part	5
- fully	1

<u>QUESTION</u>	<u>RESPONSE</u> <u>RATE</u>
11. Tax status	
- co-operative status	14
- company status	8
12. Government subsidy	
- Rural Credits	9
- Loans to Producers	1
<u>Future Co-operative Financial Arrangements</u>	
13. Future banking system arrangements/ requirements	
- as present	17
- less requirement	2
- greater requirement	3
<u>Attitudes to Concept of Co-operative Bank</u>	
14. The Co-operative Bank's role	
- wholesale bank (bank for co-operatives)	12
- commercial bank	7
15. Services required/expected	
- full services	12
- specialisation	8
16. Advantages that the bank may bring for the co-operative	
- none	9
- favourable rates	6
- additional services	1

<u>QUESTION</u>	<u>RESPONSE RATE</u>
- access to loans	8
- access to additional business	1
17. Willingness to support the concept of a co-operative bank	
- Yes	15
- No	1
- probably	3
- qualified support	1
18. Weightings to be applied to distribution of profits	
- borrower	14
- lender	3
19. Returns expected	
- as a shareholder - commercial return	22
- as a depositor - commercial return	22
- as a borrower - commercial return	18
- preferential return	3
20. Attitude to compliance with restrictions	
- happy	7
- unhappy	10
- would not comply	1
- depends	3
<u>As a Shareholder</u>	
21. Willingness to subscribe to equity	
- willing	15
- it depends	4
- unwilling	2

<u>QUESTION</u>	<u>RESPONSE</u> <u>RATE</u>
22. Acceptable equity amount	
- <\$20,000	3
- \$20-50,000	2
- \$50-100,000	3
- \$100-250,000	5
23. Returns to members	
- should be in initial interest rates	9
- should be rebate	6
- dividend	6
24. Envisaged capital structure	
- proportionate to size	14
- 3 sectors have equal share	2
- spread	4
25. Board of Directors	
- proportionate to size	11
- 3 sectors have equal share	8
- restricted voting	2
26. Direct Co-operative involvement in bank policy	
- none	21
- management through elected board	21
27. Controls over transfer of equity	
- Yes - within co-operative movement	19
- within existing equity holder categories	3

<u>QUESTION</u>	<u>RESPONSE</u> <u>RATE</u>
28. Should the Government be involved in the Co-operative Bank	
- No	5
- Yes - initially only	5
- as an equity holder	6
- as a depositor	8
29. Should the Co-operative Bank be established under	
- Statute	7
- Banking Act	10
30. Range of services to be offered (long term)	
- traditional banking services	21
31. Attitudes to compliance with restrictions	
- happy	1
- unhappy	8
- it depends	11
- would not comply	1
<u>As a Depositor</u>	
32. Willingness to deposit funds	
- No	4
- Yes - short and long term	18
33. Conditions for depositing funds with the Co-operative Bank	
- commercial return	19
- favourable return	2
- secure investment	6

<u>QUESTION</u>	<u>RESPONSE</u> <u>RATE</u>
34. Would the co-operative deposit with the Co-operative Bank for its members	
- Yes	9
- No	10
- as agency	3
35. Should members be allowed to deposit directly with the Co-operative Bank	
- Yes	15
- No	3
36. Level of services demanded of the Co-operative Bank for deposits	
- national	6
- regional	15
- local	10
<u>As a Borrower</u>	
37. Willingness to borrow funds	
- No	2
- Yes - short and long term	17
38. Conditions for borrowing funds from the Co-operative Bank	
- commercial rates	19
- favourable rates	5
39. Need for assurance for supply of funds	
- Yes	18
- No	2

<u>QUESTION</u>	<u>RESPONSE</u> <u>RATE</u>
40. Would the co-operative borrow from the Co-operative Bank for its members	
- Yes	5
- No	11
41. Should members be allowed to borrow directly from the Co-operative Bank	
- Yes	15
- No	3
42. Level of services demanded of the Co-operative Bank for borrowing	
- national	4
- regional	7
- local	11
43. Security that the co-operative would offer for loans	
- floating charge	20
- mortgage	8
- unsecured	3